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FEB 9 - 2007
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SUPREME COURT, U.S.

No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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February 9, 2007

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QUESTION PRESENTED

Whether, and to what extent, a court must consider or weigh competing inferences in determining whether a complaint asserting a claim of securities fraud has alleged facts sufficient to establish a "strong inference" that the defendant acted with scienter, as required under the Private Securities Litigation Reform Act of 1995.

PARTIES TO THE PROCEEDING

Petitioners, defendants-appellees below, are Tellabs, Inc. and Richard C. Notebaert. Additional defendants-appellees below were Michael J. Birck, Joan E. Ryan, Brian J. Jackman, Robert W. Pullen and John C. Kohler, all of whom are former officers or directors of Tellabs, Inc.

Tellabs, Inc. has no parent company, and no publicly held company owns 10 percent or more of its stock.

Respondents are Makor Issues & Rights, Ltd., a corporation appointed as lead plaintiff, and appellant below, and the individuals Chris Broholm, Richard LeBrun, David Leehey and Patricia Morris, all of whom purport to act on behalf of themselves and a class of persons similarly situated.

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OPINIONS BELOW

The opinion of the United States District Court for the Northern District of Illinois dismissing respondents' Second Consolidated Amended Class Action Complaint ("Second Amended Complaint" or "Complaint") was reported at 303 F. Supp. 2d 941 (N.D. Ill. 2004), and is reproduced at Pet. App. 28a-79a. The modified opinion of the United States Court of Appeals for the Seventh Circuit was reported at 437 F.3d 588 (7th Cir. 2006), and is reproduced at Pet. App. 1a-27a.

JURISDICTION

The court of appeals issued its original opinion on January 25, 2006. Petitioners timely sought rehearing, which resulted in an order, dated July 10, 2006, modifying the original opinion. Petitioners timely filed their petition on October 3, 2006, which was granted on January 5, 2007. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

STATUTORY PROVISION INVOLVED

Section 21D of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-4, was added by the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 747. Section 21D provides, in pertinent part:

> (2) REQUIRED STATE OF MIND.—In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

STATEMENT OF THE CASE

The Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 ("Reform Act"), was passed by Congress to deter and defeat strike suits containing weakly grounded claims under the federal securities laws. The provision of the Reform Act at issue in this case is the requirement that a complaint allege particularized facts giving rise to a "strong inference" that the defendant acted with the culpable mental state required for liability. 15 U.S.C. § 78u-4(b)(2). The culpable mental state required to support a securities fraud claim is generally referred to as "scienter." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

The Seventh Circuit in this case interpreted and applied the "strong inference" standard in a way that is inconsistent with its text and purpose. The court of appeals adopted an approach to a securities fraud complaint that rewards ambiguous pleading by reading such allegations exclusively in the plaintiff's favor, and one-sidedly considers the strength of claimed inferences of scienter by themselves, without placing the allegations putatively supporting such an inference in the context provided by the complaint and other materials properly before the court.

Contrary to the Seventh Circuit's approach, the Reform Act requires a plaintiff to plead specific facts that, considered in the overall context created by the complaint as a whole and other materials properly before the court, demonstrate that the plaintiff's claim that the defendant acted with scienter has substantial merit. Facts that, even when assumed to be true, are no more than ambiguous regarding the defendant's mental state—that are at best equally consistent with both innocence and culpability—are insufficient. The complaint here falls well below the Reform Act's heightened standard, and actually provides a model of how *not* to plead a securities fraud case under the Reform Act. This Court should reverse

the decision below, and order that the district court's dismissal of the complaint be affirmed.

A. Factual Background.

Petitioner Tellabs, Inc. ("Tellabs" or the "Company") designs highly specialized optical networks and broadband access equipment, which it markets to telecommunications carriers and internet service providers. JA 94, ¶ 2. Petitioner Richard C. Notebaert ("Notebaert") served as Chief Executive Officer and President of Tellabs during the relevant time period. *Id.* at 98, ¶ 20. Respondents, representing a proposed class of Tellabs stockholders, sued Tellabs and several of its officers and directors under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a), alleging that defendants had engaged in a scheme to inflate Tellabs' stock price for the seven-month period from December 11, 2000 through June 19, 2001.[1]

Respondents alleged that the internet and telecommunications sectors experienced a significant decline in demand beginning in the middle of 2000. JA 94, ¶ 3. As a result, Tellabs' customers "were suffering from a severe deterioration and consolidation of their businesses." *Id.* at 95, ¶ 4.

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[1] Joan Ryan (Tellabs' Chief Financial Officer during the relevant period) and Brian Jackman remain defendants only to a "control person" claim under Section 20(a), the Section 10(b) claims against them having been dismissed with no appeal taken by respondents. The Section 10(b) claim against Michael Birck, the Company's Chairman of the Board, has also been dismissed (with affirmance) but he remains a defendant to a Section 20(a) "control person" claim, as well as to a claim under Section 20A of the Securities Exchange Act of 1934, 15 U.S.C. § 78t-1(a). Pet. App. 26a-27a. These claims under Section 20(a) and Section 20A are all derivative of the Section 10(b) claims against Notebaert and the Company. While Robert W. Pullen and John C. Kohler were previously defendants in this matter, respondents expressly elected not to pursue any appeal as to them from the district court's prior dismissal rulings.

Essentially, respondents alleged that petitioners disguised the impact this decline had on Tellabs by falsely assuring investors that Tellabs' actual and expected performance remained strong.

During 2000, internet traffic significantly increased, resulting in increased demand for Tellabs' specialized network systems designed to carry such traffic. As a result, Tellabs enjoyed record sales of more than $3.3 billion in 2000, a 43% increase over 1999. JA 134, ¶ 107. Sales of its optical networking products (the key one of which was the TITAN 5500) increased by 54.1% compared to 1999. *Id.* Anticipating continued increases in internet usage and its own continued strong growth, on December 11, 2000, Tellabs projected an overall 30% growth in sales during 2001. *Id.* at 114-15, ¶¶ 75-76.

Starting on March 7, 2001, and continuing through the end of the class period (June 19, 2001), Tellabs revised its projections downward several times. Tellabs initially reduced its projections of first quarter sales slightly on March 7, 2001, announcing "below-trend growth in Tellabs' CABLESPAN® business"—a separate business line that is not the subject of any allegations here—and an inability to recognize revenue in the quarter from shipments of its new TITAN 6500 system. JA 15. On April 6, 2001, Tellabs announced a more significant reduction in its first quarter guidance, projecting sales for that quarter of about $772 million, compared with prior guidance in the range of $830 million to $865 million. *Id.* at 31. In its April 6 press release, the Company stated that "[t]he revised guidance stems from reduced and deferred spending by major communications carriers late in the quarter." *Id.* During a call with analysts that same day, Notebaert explained that in the last two and a half weeks of the quarter, certain customers had pushed some TITAN 5500 orders into the next quarter. *Id.* at 36-37. He further stated that, "[c]learly, the environment has resulted in near term caution in the pace at which customers are deploying

equipment. Our customers are exercising a high degree of prudence over every dollar spent." *Id.* at 34.

On April 18, 2001, Tellabs announced its first quarter financial results. JA 43. Although below original guidance, the results showed that the Company was still experiencing significant growth, with an increase in sales for the quarter of 21% over the same quarter from the prior year. *Id.* These results are not alleged to have been false. Pet. App. 64a.

Also on April 18, 2001, the Company reduced its full-year revenue projections from approximately $4.4 billion to a range of $3.6 to $3.7 billion. JA 44. The Company attributed the revised projections to "reduced and deferred spending by major communications carriers." *Id.* at 43. Later that day, Notebaert told analysts:

> Declining business trends we experienced late in the quarter indicate[] that we are operating in a very different environment than we were just a few short months ago. In fact, a very different environment than it was just a few weeks ago. Our customers are reviewing, and in some cases, reducing capital spending plans ....

Id. at 51.

Respondents contend that the "truth" became known on June 19, 2001. On that date, Tellabs announced substantial reductions in its prior guidance as to the second quarter and withdrew its prior guidance for the remainder of 2001. JA 144, ¶ 131. As alleged in the Complaint, the revenue shortfall for the second quarter was "due almost entirely" to a reduction in sales of the TITAN 5500 product. *Id.* at 145, ¶ 132.

According to the Seventh Circuit, the Complaint adequately stated a claim under Section 10(b) only as to Notebaert and, derivatively, the Company. Pet. App. 22a. Notebaert is not alleged to have financially benefited personally from any purported inflation in stock price during the putative class

period, nor to have attempted to do so. And the Company is not alleged to have derived any benefit at all from the seven-month period that its financial projections were allegedly inflated before voluntarily concluding a process of guidance reductions (begun during the class period) which brought its financial outlook to what are admitted to be truthful levels. Nonetheless, at issue here are those allegations that putatively give rise to a "strong inference" of scienter as to Notebaert with respect to specific false statements he is alleged to have made.

There are three categories of Notebaert's allegedly misleading statements.[2] First, statements regarding Tellabs' financial results for the fourth quarter of 2000 are alleged to have been false. Second, Notebaert is alleged to have misleadingly stated the strength of customer demand for the TITAN 5500 system, which was, at the time, Tellabs' principal product. (For the same reason, the Complaint alleges that the Company's financial projections during the class period were false.) Third, Notebaert is alleged to have misleadingly stated the availability of and demand for the TITAN 6500 system, which was then one of Tellabs' new products.

1. Respondents allege that Tellabs' financial results for the fourth quarter of 2000 were falsely inflated due to "channel stuffing" with respect to the TITAN 5500. JA 122, ¶ 86(a); *see also id.* at 128, 136, ¶¶ 95, 112. The Complaint defined "channel stuffing" broadly to include, *inter alia*, not only writing orders for products that customers did not want, but also offering discounts and incentives to entice customers to purchase products during the fourth quarter.[3] *Id.* at 110, ¶ 62.

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[2] The allegedly misleading statements by Notebaert discussed throughout are those that survived the Seventh Circuit's review.

[3] The Complaint also alleged in conclusory fashion that Tellabs had improperly back-dated orders, JA 110, ¶ 62, but the court of appeals

On the critical question of Notebaert's scienter, the Complaint alleges only that Notebaert "worked directly with Tellabs' sales personnel to channel stuff" and that he "unquestionably knew about the channel stuffing activity relating to the TITAN 5500." JA 111, 157, ¶¶ 67, 156. The Complaint does not specify which type of "channel stuffing" activity Notebaert allegedly knew about, however, or what it is he supposedly did when he "worked directly" with Tellabs' sales personnel. This failure is significant because, as the district court recognized, there is nothing improper in offering discounts and incentives to customers, which respondents had included in their definition of "channel stuffing." Pet. App. 58a, 74a. "Working with" sales personnel to "channel stuff" could thus refer to nothing more than Notebaert having participated in fashioning customer discounts. The lack of detail as to Notebaert was especially significant because the Complaint specifies alleged instances of Tellabs sending customers products they did not want. JA 111, ¶ 68. But the Complaint does not allege that Notebaert knew of those instances in particular, or of anything like them. Nothing more precise is alleged than that Notebaert knew of the broadly defined "channel stuffing."

2. Respondents have alleged that Notebaert three times misleadingly expressed continued confidence in demand for the TITAN 5500. First, in Tellabs' Annual Report for the year 2000, which was issued on February 14, 2001, Notebaert responded to a frequently asked question: "'[A]re you worried that [the TITAN 5500] has peaked'" by stating, "'No.... Although we introduced this product nearly 10 years ago, it's still going strong.'" JA 126, ¶ 91 (emphasis omitted). Second, on March 8, 2001, Notebaert allegedly responded to an analyst question about whether Tellabs was experiencing any weakness in TITAN 5500 product sales by saying, "'We're still seeing that product continue to maintain its growth rate;

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concluded that the Complaint did not provide any specifics supporting that conclusory allegation. Pet. App. 13a.

it's still experiencing strong acceptance.'" *Id.* at 132, ¶ 102 (emphasis omitted). Third, on April 6, 2001, in a conference call with analysts announcing a reduction in the Company's first quarter estimates—a reduction expressly attributed to the Company having received fewer customer orders than anticipated in the last two and a half weeks of March, and an environment in which customers were exercising greater caution with respect to spending[4]—Notebaert stated the following: "'Let me balance this a bit and say that everything we hear from our customers indicates that our in-user demand for services continues to grow.'" *Id.* at 137, ¶ 114 (emphasis omitted).[5]

The allegations with respect to Notebaert's scienter are, once again, noticeably vague. According to the Complaint, Notebaert knew his putative statements of confidence in customer demand for the TITAN 5500 were false because Tellabs had commissioned a report by Probe Research which concluded that the main source of demand for the TITAN 5500 was declining. JA 103-04, ¶ 39. In addition, a Tellabs internal marketing report allegedly concluded that TITAN 5500 revenue would decline by approximately $400 million. *Id.* But while the Complaint specifies the dates on which

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[4] "In just the last few weeks, however, we experienced a more controlled order of flow from our larger customers than we had originally anticipated. Clearly the environment has result[ed] in near-term caution in the pace at which customers are deploying equipment. Our customers are exercising a high degree of prudence over every dollar spent." JA 137, ¶ 114 (emphasis omitted) (alteration in original).

[5] The Complaint's reference to "in-user" demand for services actually refers to a comment regarding "end user" demand for services. JA 34. Regardless of the term, the context makes clear that the persons being referred to are not Tellabs' customers, but rather, the customers of those customers, whose demand for internet and other services was continuing to grow. Notebaert was pointing out that, despite the fact that ultimate "end user" demand for internet services was growing, Tellabs' own customers were increasingly cautious about purchasing new equipment. *Id.*

Notebaert allegedly falsely expressed confidence in customer demand, the Complaint fails to specify the date the Probe Research Report was received by Tellabs, or when the internal marketing report was prepared. It says only that the Probe Research Report was "*completed* in or about early 2001," and the marketing report was prepared "[i]n or about early 2001." *Id.* (emphasis added). In addition, the Complaint nowhere alleges whether the conclusions contained in either report were ever communicated to Notebaert, or if so, when.

Respondents also alleged that a confidential source reported that Tellabs had produced "internal quarterly reports" that "showed a decline in customer demand for the TITAN 5500 in March 2001." JA 104, ¶ 40. Once again, the Complaint does not specify *when* in March these internal reports first showed a decline. This omission too is significant because on April 6 Notebaert had publicly announced that there was a fall-off in orders for the TITAN 5500 *during the last two and a half weeks of March. Id.* at 34, 36-37.

3. With respect to the TITAN 6500, respondents alleged that on March 8, 2001, Notebaert falsely stated that "'[i]nterest in and demand for the 6500 continues to grow.... We continue to ship the ... 6500 through the first quarter. We are satisfying very strong demand and growing customer demand.'" JA 131, ¶ 100 (emphasis omitted). And, on April 6, 2001, in response to an analyst question whether Tellabs was on track to recognize its first revenue from the TITAN 6500 in the second quarter, Notebaert stated that, "'we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong ....'" *Id.* at 138, ¶ 117 (emphasis omitted).

Only a single paragraph of the Complaint alleges any facts relevant to Notebaert's scienter with respect to his allegedly false statements regarding the TITAN 6500. JA 107-08, ¶ 53. The allegations in that paragraph are all based on a single confidential source who was no longer with the Company at

the time that *any* of the allegedly false statements with respect to the TITAN 6500 were made. *Id.* at 91. According to the confidential source, the TITAN 6500 had suffered through a variety of development problems from 1998 through 2001, "and thereafter." *Id.* at 107, ¶ 53. The only sentence discussing Notebaert's knowledge of problems with the TITAN 6500 is conspicuously vague: "Notebaert also knew about the TITAN 6500 problems." *Id.* at 108, ¶ 53. The Complaint does not identify what problems Notebaert allegedly knew about, when he knew about them, or explain how the confidential source—who was no longer with the Company—could have known what information was available to or known by Notebaert in the spring of 2001.

B. Decisions Below.

1. After the district court appointed Makor Issues & Rights, Ltd. as lead plaintiff and approved its choice of lead counsel, respondents filed a Consolidated Amended Class Action Complaint on December 3, 2002. JA 2. The district court dismissed that complaint without prejudice on May 19, 2003, and plaintiffs filed the Second Amended Complaint (the operative Complaint here) on July 11, 2003. *Id.* at 3. The district court dismissed respondents' Second Amended Complaint in its entirety and with prejudice on February 19, 2004. Pet. App. 28a-79a.

As relevant here, the district court concluded that the Complaint adequately alleged that certain statements regarding the TITAN 5500 and the TITAN 6500 were false, including Notebaert's statements discussed above. The district court further concluded that the Complaint adequately alleged that Tellabs' fourth quarter 2000 financial statements improperly included revenues from unordered products shipped to certain customers during that quarter.[6]

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[6] The district court also ruled that, with the exception of the December 2000 revenue projection, Tellabs' projections during the class period were not actionable because they were protected by the Reform Act's safe

The district court then examined the Complaint's allegations of scienter with respect to each individual defendant, and concluded that they were insufficient to give rise to a strong inference of scienter. With respect to the allegations that Notebaert knew that Tellabs' fourth quarter 2000 financial statements were falsely inflated due to channel stuffing, the district court held that the conclusory allegations that Notebaert knew about and participated in some type of "channel stuffing" were insufficient to create a strong inference that Notebaert knew of any *improper* "channel stuffing." Pet. App. 74a. The court noted that the Complaint did not specify what channel stuffing activities Notebaert allegedly participated in: "Such allegations are critical because the Court has concluded that there is nothing inherently wrong with several of Plaintiffs' channel stuffing allegations." *Id.* In fact, the district court had, in its prior ruling dismissing the earlier complaint, told the plaintiffs that their allegations of scienter regarding "channel stuffing" inappropriately encompassed conduct that was innocent. *Id.* at 99a-100a.

The district court also considered the Complaint's allegations regarding the Probe Research Report and the internal marketing reports. In concluding that the allegations regarding these reports did not support a strong inference of Notebaert's scienter, the district court noted that the allegations lacked "significant details," including the precise dates of these reports, which were important given the chronology of statements. Pet. App. 65a.

Finally, the district court concluded that the Complaint's general allegations regarding "Notebaert's position in the company and general conclusions concerning his knowledge of the allegedly fraudulent activities without providing

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harbor. Pet. App. 45a (citing 15 U.S.C. § 78u-5(c)(1)(A)(i) & (ii)). The Seventh Circuit disagreed and concluded that none of the projections was protected by the Reform Act's safe harbor. *Id.* at 16a. This issue is not before this Court.

particulars to reinforce their general conclusions" could not support a strong inference of scienter with respect to any of the alleged misstatements, including the statements regarding the TITAN 6500. Pet. App. 74a.

2. Respondents appealed. The Seventh Circuit reversed the district court's dismissal of the Section 10(b) claims as to Notebaert and, derivatively, the Company. After identifying the allegedly false statements that were pled with sufficient specificity potentially to support a claim, Pet. App.10a-16a, the court of appeals turned to the issue of scienter.

The court focused on "the degree of imagination courts can use in divining whether a complaint creates a 'strong inference.'" Pet. App. 20a. The Seventh Circuit concluded that a complaint should survive "if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." *Id.*

The Seventh Circuit then applied this reasonable person standard to the Complaint's allegations regarding Notebaert.[7] The court concluded that allegations that Notebaert "knew" about and "'worked directly with Tellabs sales personnel'" to effect "channel stuffing" were sufficient to establish a strong inference that Notebaert knew that purchase orders had been fabricated for products that certain customers had not ordered, and therefore knew that Tellabs' fourth quarter 2000 financial

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[7] The only other individual defendant as to whom respondents appealed the dismissal of their Section 10(b) claim was Michael Birck, Tellabs' Board Chairman. The court held that the Complaint did not adequately allege facts supporting the claim that Birck acted with scienter. The only statement attributed to Birck was a February 2001 statement informing investors that the TITAN 5500 was "'still going strong.'" The court determined, however, that "it was not until March 2001 that the TITAN 5500's declining status was obvious." Pet. App. 24a. The court also determined that the Complaint's allegations regarding Birck's alleged insider trading lacked sufficient particularity. Pet. App. 23-24a.

statements were misstated.[8] Pet. App. 25a. The court simply ignored what the district court had twice pointed out: that the allegations of "channel stuffing" were broad enough to include innocent conduct (offering discounts and incentives to customers) that would not support an inference of scienter at all, and that no specificity whatsoever had been provided as to what exactly Notebaert had allegedly done or known.

In addressing the allegations that Notebaert knew that his statements regarding the TITAN 5500 were false when made, the Seventh Circuit relied on allegations with respect to the Probe Research Report and certain internal reports. The court recognized that under the Complaint's allegations it was "conceivable" that Notebaert had not seen these reports when he made his statements. Nonetheless, the court found that "plaintiffs have provided enough for a reasonable person to infer that Notebaert knew that his statements were false." Pet. App. 23a. The court noted, but quickly set aside, the vagueness of the allegations regarding the timing of both the Probe Research Report and the internal reports, focusing instead on the general notion that Notebaert "stayed on top of the company's financial health" and that the TITAN 5500 was an important product to the Company. *Id.* Such general and vague allegations were, according to the court, sufficient to create a strong inference of scienter.

Finally, with respect to Notebaert's statements regarding the TITAN 6500, the court simply misstated the allegations of the Complaint. The court believed that a confidential informant had alleged that Notebaert "knew that 'the TITAN 6500 was not ready for deployment despite Tellabs' public announcements.'" Pet. App. 25a (alteration omitted). That

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[8] The Seventh Circuit found that the only claim that respondents had pleaded with sufficient particularity in regard to the alleged falsity of the fourth quarter 2000 financial statements was that certain of Tellabs' customers had been sent unordered TITAN 5500s. Pet. App. 25a.

was incorrect.[9] Only one sentence in the Complaint directly talked about Notebaert and the TITAN 6500, and it stated only that, according to a source, Notebaert knew of "problems" with the TITAN 6500, without specifying which "problems" Notebaert knew of or how. JA 107-108, ¶ 53. This absence of detail was signifcant because the source had admittedly left the Company prior to the class period, and referred to problems with the development of the product dating back to 1998. *Id.* The Seventh Circuit also relied on an allegation that Notebaert "saw weekly sales reports and production projections," Pet. App. 24a-25a, which is actually a combination of two different allegations, neither of which makes any specific reference to the TITAN 6500. One refers to a generalized allegation that "Tellabs management viewed weekly and monthly reports concerning a variety of issues, including the status of product development." JA 155, ¶ 153(f) (emphasis omitted). The other specifically mentions Notebaert, but alleges only that he "had telephone calls every day and stayed on top of everything," and that he had discussions with other executives who had weekly revenue calls. *Id.* at 155-56, ¶ 153(g). The court nonetheless concluded that these generalized allegations supported a "strong inference" of scienter. Pet. App. 25a.

The Seventh Circuit not only accepted the patently ambiguous allegations regarding Notebaert's alleged scienter, but it ignored the broader context that undermined whatever weak inference of scienter otherwise existed. The court simply ignored the fact that Tellabs reduced its revenue projections repeatedly during a period in which it was alleged to have been artificially inflating its stock price by creating false expectations. In addition, the Seventh Circuit never

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[9] The Complaint actually alleges that two other defendants, Jackman and Pullen, whose dismissals with respect to the Section 10(b) claims were not challenged on appeal by respondents, knew that the TITAN 6500 was not ready for disbursement despite public announcements to the contrary. JA 107, ¶ 53.

acknowledged or addressed the fact that the Complaint had not alleged any motive for Notebaert artificially to have inflated Tellabs' stock price for a limited seven-month period during which neither he nor the Company is alleged to have derived any financial benefit from the fraud. Instead, the ambiguous allegations discussed above, viewed without reference to the full picture drawn by the Complaint and other materials properly before the court, were deemed sufficient to satisfy the "strong inference" standard.

SUMMARY OF ARGUMENT

The plain language of the Reform Act makes clear that Congress intended to change the pleading paradigm with respect to allegations of scienter in securities fraud cases. By requiring plaintiffs to "state with particularity facts giving rise to a strong inference" of scienter, 15 U.S.C. § 78u-4(b)(2), Congress signaled a clear break from the general notice-pleading rule embodied in Fed. R. Civ. P. 8(a) and the permissive rule regarding general averments of intent in Fed. R. Civ. P. 9(b).

Congress has heightened the pleading burden with respect to allegations of scienter for a private plaintiff asserting a claim of securities fraud under the 1934 Act in two critical respects. First, the "particularity" requirement requires a plaintiff to plead specific facts from which an inference that the defendant acted with scienter may be drawn. Rule 9(b), which on its face permits general averments of a defendant's mental state, is thus superseded in federal securities fraud cases. Second, and of central concern in this case, the specifically pled facts must create a "strong" inference of scienter. Determining the strength of the inference of scienter requires a court to consider the plausibility of the assertion that the defendant acted with scienter in light of the specific facts pled—including facts that serve to undermine any such claimed inference. This requirement is a fundamental shift away from the familiar role of a modern complaint, which, in

the typical case, need only provide notice of the basic nature and circumstances of the claim. By contrast, the Reform Act imposes a burden on the plaintiff to plead specific facts that, if proven to be true, cogently demonstrate a substantial claim as to scienter that meaningfully tends to exclude innocent possibilities. Thus, if a plaintiff is able to do no more than allege facts that are, at most, equally consistent on their face with either innocence or culpability—despite the benefit of having all well-pleaded facts treated as true, and being the master of what to include in the complaint—a "strong inference" of scienter does not exist and the complaint should be dismissed.

The requirement that a federal securities fraud pleading paint a cogent picture of the substantial merit of the plaintiff's claim of scienter is critical to advancing the fundamental purpose of the Reform Act. Through the Reform Act, Congress sought to deter and defeat the abusive practice of securities fraud strike suits. Congress perceived that the typical roadblocks against insubstantial claims, discovery and summary judgment, were not effectively weeding out meritless securities fraud claims. Congress concluded that the high costs of discovery, and the potential bet-the-company nature of securities fraud suits, too often forced companies to settle even meritless claims for substantial sums whenever a complaint survived a motion to dismiss on the pleadings. The result was a legal regime that undermined the goals that the securities laws are supposed to advance, in particular encouraging a free-flow of information delivered to the market regarding publicly traded companies. An omnipresent threat of litigation discourages public statements about a company's future prospects. By requiring plaintiffs to plead facts sufficient to show a substantially meritorious scienter claim, Congress changed this perverse legal environment.

In light of the Reform Act's language and purpose, certain principles emerge for evaluating whether a securities fraud complaint's allegations give rise to a "strong inference" of

scienter. First, a court should consider and weigh all the allegations of the complaint, along with all other materials properly before it, including facts that support an inference of innocence. Even if a well pled fact might support some inference of scienter in isolation, the inference may not be "strong" in light of the overall context, including other facts properly before the court. Any rule that permits courts to ignore the facts that suggest an innocent mental state would allow precisely the kinds of doubtful, speculative claims to proceed that Congress clearly intended to deter and prevent.

Second, the absence of certain allegations from a complaint is also relevant. In particular, both before and after the Reform Act, courts have appropriately recognized that the presence or absence of allegations of motive to engage in fraud is particularly important for determining whether the complaint creates a "strong inference" of scienter. The absence of a cogent economic motive to engage in unlawful conduct substantially weakens any inference of scienter, because courts do not lightly assume that individuals behave illegally for no reason. Once again, allowing such claims to proceed would reintroduce the harms of weakly grounded claims that Congress intended to eliminate.

Third, the language and purpose of the Reform Act require that certain commonly employed, ambiguous pleading strategies not count in a plaintiff's favor. Allegations that are as consistent with innocence as with culpability do not satisfy the "strong inference" requirement and should not suffice to survive a motion to dismiss; rather, the facts alleged must meaningfully tend to exclude the possibility of innocence. There are at least two different types of such ambiguous allegations. What might be called "strategic ambiguity" leaves out significant details that would clarify whether the identified conduct was either innocent or culpable. Other ambiguous allegations include facts that one might expect to be true in the event the defendant acted illegally, but one would also expect to see even if the defendant were acting

innocently. Both types of ambiguous allegations do no more than raise the possibility of scienter, without meaningfully tending to exclude innocent explanations. Allowing claims based on such allegations to proceed would effectively reinstitute the pre-existing regime that Congress rejected for securities fraud claims. Congress did not wish to wait until later in the litigation to allow the plaintiff to uncover facts that tend to exclude an innocent explanation.

A review of the allegations in the Second Amended Complaint, in light of the "strong inference" standard properly construed, reveals that the Seventh Circuit erred in ordering the case to proceed. The Seventh Circuit repeatedly credited ambiguities in respondents' favor and ignored all facts that undercut the scienter charge.

Respondents claim, for example, that Notebaert knew his statements regarding demand for the TITAN 5500 were false because they have alleged that a report by Probe Research, as well as certain internal reports, stated that 2001 revenue for the TITAN 5500 would decline. But, critically, the Complaint does not allege with precision when these reports were delivered or when, if ever, their conclusions were made known to Notebaert. As a result of this ambiguity, these allegations are at most equally consistent with innocence and culpability; yet the Seventh Circuit indulged respondents. What is more, during the seven-month period of alleged fraud, Notebaert caused the Company to revise *downward* its projections several times, including in April 2001, when he publicly announced a fall-off in orders experienced in the latter part of March and reduced projected revenues for the year by $800 million (approximately 18%). This conduct, which is entirely inconsistent with the alleged scheme to defraud, fatally undermines even the ambiguous and weak inference of scienter that can be drawn from the facts alleged; but the Seventh Circuit declined to take any account of it.

Similarly ambiguous are respondents' allegations that Notebaert knew about and participated in some form of

"channel stuffing," which respondents claim create a strong inference that Notebaert knew that Tellabs' fourth quarter of 2000 financial statements were falsely inflated. The Complaint defines "channel stuffing" to include both innocent conduct (such as offering discounts and extended payment terms) and culpable conduct (such as shipping unordered products to customers). Yet the Complaint strategically avoids alleging which type of "channel stuffing" Notebaert knew about. Here again, the Complaint alleges only facts that are as consistent with innocent conduct as with culpable conduct.

The bare allegation that Notebaert knew of "problems" with the TITAN 6500 is also far too ambiguous to support a "strong" inference of scienter. Neither is the strong inference standard satisfied by the general allegation that Notebaert, like other executives at the Company, was kept apprised generally of the Company's business. Such allegations not only fail specifically to tie Notebaert's knowledge to details about the TITAN 6500, but they are also the kind of facts that are as likely to be true in cases of innocence as culpability. Executives are *always* kept regularly apprised of the company's overall financial condition. Such a generally true allegation cannot support a strong inference of fraudulent intent.

Finally, respondents allege no facts that suggest why Notebaert would have suddenly commenced a fraud in December 2000, and then, just as suddenly, stopped seven months later. Neither Notebaert nor the Company is alleged to have received any economic benefit at all in the interim from this temporally circumscribed fraud. The absence of any reason for Notebaert to have engaged in fraud places an especially heavy burden on respondents to produce allegations that directly and strongly suggest Notebaert knew he was misleading the public. Respondents did not even come close to meeting their burden.

ARGUMENT

I. THE REFORM ACT REPLACES THE NOTICE PLEADING REGIME OF THE FEDERAL RULES WITH A REQUIREMENT THAT THE PLAINTIFF PLEAD FACTS THAT DEMONSTRATE A SUBSTANTIAL CLAIM AS TO A DEFENDANT'S SCIENTER.

A. The Federal Rules' Notice Pleading Approach.

The 1938 promulgation of the Federal Rules of Civil Procedure greatly simplified the task of pleading, which was so complicated at common law and under the codes that it was "virtually impossible logically to distinguish" between proper and improper pleading. J.B. Weinstein & D.H. Distler, *Comments on Procedural Reform: Drafting Pleading Rules*, 57 Colum. L. Rev. 518, 520-21 (1957); see generally C.E. Clark, *Simplified Pleading*, 2 F.R.D. 456, 458-64 (1943) (discussing historical evolution of pleading and simplifications brought about by the federal rules); compare, *e.g.*, W.W. Cox, *Statements of Fact in Pleading under the Codes*, 21 Colum. L. Rev. 416, 417-22 (1921) (describing some of the potential pitfalls of pleading prior to the federal rules). While older pleading rules sought, among other things, to "narrow[] the issues that must be litigated" and "provid[e] a means for speedy disposition of sham claims and insubstantial defenses," the technical requirements that grew up around those rules often led to cases being dismissed "without regard to the merits of the controversy." 5 C. Wright & A. Miller, *Federal Practice and Procedure: Civil* § 1202, at 88 (3d ed. 2004).

Modern pleading rules have struck a different balance. A modern complaint is designed merely to put the defendant on notice of the subject matter of the claim, and allow the litigation to proceed to a decision on the merits. "[T]he Federal Rules of Civil Procedure do not require a claimant to set out in detail the facts upon which he bases his claim. To

the contrary, all the Rules require is 'a short and plain statement of the claim' that will give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests." *Conley* v. *Gibson*, 355 U.S. 41, 47 (1957) (footnote omitted).

The notice-pleading regime allows claims to proceed based on a "'reasonably founded hope that the [discovery] process will reveal relevant evidence'" to support the claim. *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 347 (2005) (alteration in original) (quoting *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 741 (1975)). This lax standard for pleading provides plaintiffs "an incentive to plead vaguely in hopes that discovery will turn up material on which to base a more specific charge." R. Marcus, *The Revival of Fact Pleading under the Federal Rules of Civil Procedure*, 86 Colum. L. Rev. 433, 445-46 (1986). The pleading rules expect that some cases may be filed without the plaintiff knowing much of the details that may ultimately be relied upon to establish liability. *Swierkiewicz* v. *Sorema N.A.*, 534 U.S. 506, 511-12 (2002) (Rule 8 does not require a plaintiff in an employment discrimination case to plead facts establishing a *prima facie* case because discovery might later uncover direct evidence of discrimination that would support the claim on the merits).

The generally applicable notice pleading standard was purposefully set low in light of the overall structure of the Rules. The "simplified notice pleading standard relies on liberal discovery rules and summary judgment motions to define disputed facts and issues and to dispose of unmeritorious claims." *Swierkeiwicz*, 534 U.S. at 512; *Celotex Corp.* v. *Catrett*, 477 U.S. 317, 327 (1986). As a result, on a motion to dismiss in a typical case, the "issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims. Indeed it may appear on the face of the pleadings that a recovery is very remote and unlikely but that is not the test." *Scheuer* v. *Rhodes*, 416 U.S. 232, 236 (1974).

Rule 9(b) states that a greater degree of factual specificity is required with respect to the "circumstances constituting fraud." This requirement is a deviation from the general rule. See *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168 (1993).[10] But the paradigm of notice pleading is specifically preserved on the face of Rule 9(b) as to allegations of "[m]alice, intent, knowledge, and other condition of mind." Such allegations, according to the terms of the Rule, "may be averred generally." Fed. R. Civ. P. 9(b).

Shortly prior to passage of the Reform Act, this Court suggested in *Leatherman* that Rule 9(b) should be read literally, and that its particularity requirement should be limited to the matters specifically identified as subject to it. 507 U.S. at 168; see *Jones* v. *Bock*, No. 05-7058, slip op. at 12 (U.S. Jan. 22, 2007) ("'Specific pleading requirements are ... not [mandated], as a general rule, through case-by-case determinations of the federal courts.'") (quoting *Hill* v. *McDonough*, 126 S. Ct. 2096, 2103 (2006)).[11] As the Ninth Circuit observed, *Leatherman* called into question efforts developed by other courts, discussed below, *infra* at 31-33, to require securities fraud plaintiffs to plead specific facts giving rise to a strong inference of scienter. *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541 (9th Cir. 1994) (en banc). The Ninth

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[10] At common law and under the codes, "a higher degree of certainty and more specific details were required in the declaration in actions which were disfavored because of their nature, or in which the defendant's morality was brought in question." C.E. Clark, *Handbook of the Law of Code Pleading* § 48, at 311-12 (2d ed. 1947)).

[11] Whether in certain cases the underlying substantive law at issue might, as a matter of judicial interpretation and application of Rule 8, affect the level of factual detail required in a pleading is under this Court's consideration in *Bell Atlantic* v. *Twombly*, No. 05-1126 (U.S. argued Nov. 27, 2006). That issue is not directly presented here because Congress has specifically addressed itself to the pleading standard for securities fraud cases, as discussed below.

Circuit reasoned that while those efforts may be based in sound policy considerations regarding the need to deter and defeat the too-frequent practice of securities fraud strike suits, "[w]e are not permitted to add new requirements to Rule 9(b) simply because we like the effects of doing so. This is a job for Congress, or for the various legislative, judicial, and advisory bodies involved in the process of amending the Federal Rules." *Id.* at 1546. On this view, the failure to plead specific facts to support allegations of scienter would not prevent a securities fraud claim from following the path that the Federal Rules contemplated for most cases: quickly past the pleadings and on to discovery for ultimate consideration on the merits.

B. The Language, Structure And Legislative History Of The Reform Act Make Clear That Congress Displaced The Federal Rules' Approach To Pleading And Required Specific Facts That Demonstrate A Substantially Meritorious Claim As To Scienter.

In the Reform Act, Congress provided the specific authority for the aggressive review of securities fraud complaints, and especially scienter allegations, that the Ninth Circuit in *GlenFed* believed had been lacking.[12] The Reform Act establishes standards and procedures that require a review of the pleadings focusing on far more than the adequacy of notice. A court is required to consider whether the facts alleged in the complaint strongly show the promise or substantial merit in a plaintiff's claim of scienter. The court thus reviews the complaint with an eye on the plaintiff's ultimate prospects for success based on what facts the plaintiff can allege *prior* to discovery. Such review

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[12] When passing the Reform Act, Congress was aware that "the courts of appeals [had] interpreted Rule 9(b)'s requirement in conflicting ways, creating distinctly different standards among the circuits." H.R. Conf. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740.

necessarily involves consideration not only of the facts the plaintiff suggests support an inference of scienter, but of all the facts alleged in the complaint as a whole, along with all other facts properly considered at the pleading stage.

The legislative history explains why Congress chose to break from the ordinary procedure of delaying any consideration of the claim's prospects for success until *after* the plaintiff has access to discovery. A substantial premise of the notice pleading approach, that summary judgment proceedings can quickly dispose of weak claims after the pleadings, had proved false in securities fraud cases. Defendants were being forced by the economic realities of securities litigation to settle even meritless claims that proceeded beyond the pleadings. Congress's response to the troubling frequency of strike suits in securities litigation built and expanded upon concerns expressed by courts that had identified the seriousness of the problem prior to the Reform Act.

1. The Reform Act strikingly places great emphasis on the pleading of specific facts in support of a securities fraud claim. "[E]ach statement alleged to have been misleading" must be specified. 15 U.S.C. § 78u-4(b)(1). In addition, "the reason or reasons why the statement is misleading" must also be specified. *Id.* And when allegations are made on information and belief regarding the allegedly misleading statements, "the complaint shall state with particularity *all* facts on which that belief is formed." *Id.* (emphasis added).

The text quickly makes clear that part of the reason for requiring such factual specificity with respect to the allegedly misleading statements is to facilitate judicial scrutiny of the allegations of scienter. The "complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts" supporting the allegation of scienter. *Id.* § 78u-4(b)(2). The particularity requirement as to facts supporting an inference of scienter squarely rejects permitting

scienter to be averred generally, as a literal reading of Rule 9(b) would require.

Most importantly, Congress went beyond requiring the pleading of particularized facts with respect to scienter. Congress chose to specify that the pleading must state particularized "facts giving rise to a *strong* inference" of scienter. *Id.* (emphasis added). The requirement of a "strong inference" of scienter is the clearest textual evidence of the break from a notice pleading regime in the Reform Act. The notion of requiring a pleading to make a "strong" case, or even to present allegations that "strongly" support an element of a claim, is entirely foreign to notice pleading. The adjective "strong" has nothing to do with identifying the issues in dispute. If Congress wanted the complaint merely to identify issues to open the door to discovery, then it could have required specific facts giving rise to "an inference" of scienter. Instead, it chose to require a "strong inference," which in this context means "compelling" or "capable of making a clear or deep impression esp[ecially] on the mind." *Webster's Third New International Dictionary of the English Language Unabridged* 2265 (1993). The word is one of force and effectiveness, not notice. *The American Heritage Dictionary* 1369 (2004) (defining "strong" as "persuasive, effective, and cogent").

Taken together, the emphasis on particularity in pleading and the "strong inference" requirement with respect to scienter put a heavy burden on a securities fraud pleader. The complaint must do more than tell the defendant at a high level of specificity what facts are likely to be the focus of the dispute. The Reform Act requires the complaint to paint a detailed picture of the facts that meaningfully tends to exclude the possibility of innocence and cogently shows that

the plaintiff's claim that the defendant acted with scienter has substantial merit.[13]

The procedure the Reform Act establishes supports interpreting the "strong inference" standard to require a substantially meritorious case before access to discovery. The Reform Act insists that the plaintiff marshal factual allegations without access to discovery. Discovery often proceeds during the pendency of a motion to dismiss in other litigation. See 8 C. Wright et al., *Federal Practice and Procedure* § 2008 (2d ed. 2006) ("Discovery is not to be denied because it relates to a claim or defense that is being challenged as insufficient."). Under the Reform Act, however, discovery is, as a general rule, stayed during the pendency of the motion to dismiss. 15 U.S.C. § 78u-4(b)(3)(B). The Reform Act is so opposed to a plaintiff using discovery to ferret out support for a complaint that it even provides for an order staying discovery in related *state* court cases. *Id.* § 78u-4(b)(3)(D).

2. The legislative history of the Reform Act fully supports what the text and structure of the Act reveal. Congress decided to change the litigation process in a way that deterred the filing of "roll-the-dice," speculative securities fraud suits, and equipped courts and defendants with further mechanisms to dismiss such suits before the costly discovery process began.

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[13] As discussed more fully below, *infra* at 30-31, this standard functions similarly to this Court's antitrust decisions, which require a plaintiff to "present evidence 'that tends to exclude the possibility'" that the defendants acted innocently. *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 588 (1986) (quoting *Monsanto Co.* v. *Spray-Rite Serv. Corp.*, 465 U.S. 752, 764 (1984)). In addition, and as discussed more fully below, this standard was also adopted for reasons similar to this Court's rationale for interpreting "antitrust law [to] limit[] the range of permissible inferences" that would warrant further litigation. *Matsushita*, 475 U.S. at 588.

Congress passed the Reform Act and strengthened the pleading requirements for scienter because it found that Rule 9(b) had "not prevented abuse of the securities laws by private litigants." H.R. Conf. Rep. No. 104-369, at 41 (1995) ("H.R. Rep."), *reprinted in* 1995 U.S.C.C.A.N. 730, 740; see *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Dabit*, 126 S. Ct. 1503, 1510-11 (2006) (explaining that Congressional policy behind the Reform Act was to defeat abusive litigation practices). Congress had found that "[a] complaint alleging violations of the Federal securities laws is easy to craft and can be filed with little or no due diligence." S. Rep. No. 104-98 (1995), at 8 ("S. Rep."), *reprinted in* 1995 U.S.C.C.A.N. 679, 687. Congress was aware of the "the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action." H.R. Rep. at 31, *reprinted in* 1995 U.S.C.C.A.N. at 730.

Securities fraud suits are particularly subject to meritless strike suits. See generally, Amicus Br. of SIFMA & Chamber of Commerce 6-9. The cost to the defendant of litigating greatly exceeds the cost to the plaintiff. Corporate defendants not only must pay for attorneys, but also must consider the "disruption of normal business activities," *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 743 (1975), that is occasioned by complying with typically massive document requests and time lost for depositions. W. Baskin, Note, *Using Rule 9(b) to Reduce Nuisance Securities Litigation*, 99 Yale L.J. 1591, 1596-97 (1990) (discussing differential in incentives to continue in litigation rather than settle between defendants and plaintiffs in securities cases); H.R. Rep. at 37, *reprinted in* 1995 U.S.C.C.A.N. at 736 ("[T]he threat that the time of key employees will be spent responding to discovery requests, including providing deposition testimony, often forces coercive settlements."). In addition, many cases

involve potentially crippling claims against the company, especially if, as is often the case, the suit was precipitated by a substantial drop in stock price. The inherent uncertainties of litigation create powerful incentives for companies to settle rather than defend a bet-the-company suit. Settlement in such circumstances is often driven by factors far removed from the merits. S. Rep. at 7, *reprinted in* 1995 U.S.C.C.A.N. at 686 ("If a defendant cannot win an early dismissal of the case, 'the economics of litigation may dictate a settlement even if the defendant is relatively confident that it would prevail at trial.'") (quoting the testimony of SEC Chairman Arthur Levitt); J. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 501 (1991) (finding that the merits do not affect settlement outcomes in securities fraud lawsuits).

The litigation process in securities fraud cases had been transformed from a means for resolving disputes to an incentive for plaintiffs' counsel to create disputes where none ought to exist. As this Court observed,

> in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.

Blue Chip Stamps, 421 U.S. at 740.

The litigation process was thus undermining the policies of securities regulation. One of the principal policies of the securities laws is to encourage disclosure of information regarding publicly traded companies. *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). "Abusive litigation severely affects the willingness of corporate managers to disclose information to the marketplace." H.R. Rep. at 42, *reprinted in* 1995 U.S.C.C.A.N. at 741. Private

securities class actions, however, "inhibit free and open communication among management, analysts, and investors." S. Rep. at 5, *reprinted in* 1995 U.S.C.C.A.N. at 684. Public companies fear that releasing information makes them vulnerable to attack. "As a result, investors often receive less, not more, information, which makes investing more risky and increases the cost of raising capital." *Id.* As this Court succinctly observed, Congress's motivation behind the Reform Act was to defeat abusive litigation practices that "resulted in extortionate settlements, chilled any discussion of issuers' future prospects, and deterred qualified individuals from serving on boards of directors." *Dabit*, 126 S. Ct. at 1510-11.[14]

Because the private litigation process itself was undermining the goals of the securities laws, Congress fundamentally changed that process. Significantly, Congress applied the "strong inference" standard only to *private* suits brought under the 1934 Act. 15 U.S.C. § 78u-4(b)(2). The pre-Reform Act pleading standard thus remains unchanged for suits brought by the SEC. This result reflects Congress's considered view that the typical private securities fraud suit was no longer serving the public interest in the way that suits brought by the SEC do. Amicus Br. of SIFMA & Chamber of Commerce 17-19 (discussing SEC willingness and ability to enforce securities laws).

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[14] It was also clear that the securities litigation regime then in place was causing capital to flee from the United States. H.R. Rep. No. 104-50, at 20 (1995) ("Fear of litigation keeps companies out of the capital markets."). As a recent report by the independent, bipartisan Committee on Capital Markets Regulation found, "the United States is losing its leading competitive position as compared to stock markets and financial centers abroad." *Interim Report of the Committee on Capital Markets Regulation* at ix (Nov. 30, 2006), *available at* http://capmktsreg.org/research.html. "Foreign companies commonly cite the U.S. class action enforcement system as the most important reason why they do not want to list in the U.S. market." *Id.* at 11; see generally, Amicus Br. of SIFMA & Chamber of Commerce 9-12.

In strengthening the pleading requirements for stating a private securities fraud claim, Congress "sought to strike the appropriate balance between protecting the rights of victims of securities fraud and the rights of public companies to avoid costly and meritless litigation." S. Rep. at 10, *reprinted in* 1995 U.S.C.C.A.N. at 689. The pleading standard adopted in the Reform Act, which imposes substantial pre-complaint investigation costs on the plaintiff, advances Congress's goal of deterring nonmeritorious suits by increasing the costs to a plaintiff of filing a suit that has a chance of producing a settlement. By authorizing substantive review of the complaint by a court to ensure that the plaintiff has uncovered facts that, if proved, present a cogent picture of a claim with significant merit, Congress instructed that strike suits lacking significant merit be dismissed before they could cause substantial harm.

The "strong inference" standard bears resemblance to the approach this Court has taken in reviewing claims under the antitrust laws. This Court has itself recognized that, in antitrust cases, courts should apply procedural rules in a way that protects against the potential of litigation itself to undermine the public policies advanced by the underlying substantive law. In *Matsushita Electrical Industrial Co.* v. *Zenith Radio Corp.*, this Court precluded a trial in a price fixing conspiracy case, recognizing that "*mistaken* inferences in cases such as this one are especially costly, because they chill the very conduct the antitrust laws are designed to protect." 475 U.S. 574, 594 (1986) (emphasis added). In light of the fact that litigation based on evidence supporting only weak inferences of anticompetitive conduct threatened to deter procompetitive behavior, this Court applied the summary judgment standard in a way that balanced the need to protect against harmful mistaken inferences with "the desire that illegal conspiracies be identified and punished." *Id.* It did so as a matter of law by narrowing the range of permissible inferences that might be drawn from facts in such

cases. See also *Monsanto Co.* v. *Spray-Rite Serv. Corp.*, 465 U.S. 752, 762-64 (1984).

The fact that in the Reform Act Congress chose to narrow the range of permissible inferences *at the pleading stage* does not make *Matsushita* and *Monsanto*, which are summary judgment decisions, any less instructive. Both this Court's antitrust decisions and the Reform Act's "strong inference" standard are a response to the need to narrow the range of permissible inferences to protect the underlying policies of the relevant substantive federal law (antitrust and the securities laws, respectively) from harms caused by further litigation. As discussed above, Congress chose not to wait for the summary judgment stage to narrow the range of permissible inferences in securities cases because it determined that the litigation process was undermining the policies of the securities laws by too often forcing defendants to settle meritless claims long before the summary judgment stage. In the end, Congress has followed this Court's direction in *Leatherman*, 507 U.S. at 168, to provide express statutory authority for special pleading standards when it concludes that public policy warrants exempting a specific cause of action from the generally applicable rules.

3. By requiring a securities fraud complaint to paint a cogent picture of a substantially meritorious claim as to scienter, Congress was codifying, strengthening, and making uniform a procedure that certain courts of appeals had already begun to develop. Numerous courts had concluded prior to the Reform Act that a federal securities fraud complaint needed to allege specific facts that would support an inference of scienter. *E.g.*, *Ross* v. *A.H. Robins Co.*, 607 F.2d 545, 558 (2d Cir. 1979) (affirming dismissal where plaintiffs did not allege a "strong inference" that the defendants had knowledge of undisclosed facts); *Greenstone* v. *Cambex Corp.*, 975 F.2d 22, 25-27 (1st Cir. 1992) (Breyer, J.) (a securities fraud complaint must "set forth specific facts that make it reasonable to believe that [the] defendant knew that [the]

statement was materially false or misleading"); *DiLeo* v. *Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (affirming dismissal where "the complaint offers no reason to infer that [the defendant] possessed the mental state necessary for a primary violation [of Section 10(b)]"); *Tuchman* v. *DSC Communications Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994) ("To plead scienter adequately, a plaintiff must set forth specific facts that support an inference of fraud."). The Second Circuit specifically required that the inference of scienter drawn from the allegations had to be "strong," *Ross*, 607 F.2d at 558, whereas other courts required facts that created a "reasonable" inference of scienter, *Greenstone*, 975 F.2d at 25, or merely "an inference" of scienter, *Tuchman*, 14 F.3d at 1068.

These courts recognized this requirement as an extension of the traditional rationale behind requiring particularity with respect to the circumstances constituting fraud: the need to safeguard a defendant's reputation or goodwill from improvident charges of wrongdoing. *Shields* v. *Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994). But these courts were also using the complaint to evaluate the prospects of success in securities fraud claims. *DiLeo*, 901 F.2d at 629 (stating that in order to survive a motion to dismiss, a securities fraud complaint "must afford a basis for believing that plaintiffs could prove scienter"); *Greenstone*, 975 F.2d at 27 (affirming dismissal of complaint for failure to plead scienter because the facts in support of an inference of scienter were "not strong enough to bear the great overarching weight ... the plaintiff wishes [them] to support" and because the "inferential links are weak"); M. Louis, *Interpreting and Discouraging Doubtful Litigation*, 67 N.C. L. Rev. 1023, 1040 n.118 (1989) (stating that judges requiring specific facts supporting inference of scienter were seeking a "demonstration that the plaintiff has a bona fide, provable claim"); Note, *Pleading Securities Fraud with Particularity Under Rule 9(b)*, 97 Harv. L. Rev. 1432, 1442 & n.52 (1984)

(stating that dismissals for failure to satisfy Rule 9(b) "require the judge to make at least a preliminary judgment on the merits of the complaint").

This focus on whether a securities fraud complaint showed promise for success on the merits was driven, even prior to the Reform Act, by a recognition that securities fraud claims were particularly subject to strike suits, and that meritless litigation in this context undermined the very policies that the securities laws sought to advance. *E.g.*, *Ross*, 607 F.2d at 557; *Shields*, 25 F.3d at 1128; *Tuchman*, 14 F.3d at 1067; *Wayne Inv., Inc.* v. *Gulf Oil Corp.*, 739 F.2d 11, 13 (1st Cir. 1984). Courts perceived that the rules generally favoring notice, and litigation on the merits beyond the pleadings, had to be tempered by the concern against allowing "the use of the litigation process as a device for extracting undeserved settlements as the price of avoiding the extensive discovery costs that frequently ensue once a complaint survives dismissal." *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 263 (2d Cir. 1993). These courts believed it was their responsibility to work out a rough balance between these competing interests on a case-by-case basis, in light of the absence of a clear standard in the securities statutes or procedural rules. *Id.* at 264. In the Reform Act, Congress has both endorsed that effort and provided substantive direction for how to carry out the task: Congress has chosen to give access to compulsory discovery only to plaintiffs whose factual allegations demonstrate strong promise on the merits while keeping weakly grounded claims out of court.

C. The Text And Purpose Of The Reform Act Reveal Principles For Evaluating Whether A Complaint Alleges Facts Creating A Strong Inference Of Scienter.

The change in orientation to the adequacy of a complaint under the Reform Act is important. But at least as important are the readily applicable principles for evaluating certain common categories of allegations that emerge from the text

and purpose of the Reform Act. Whatever verbal formulation this Court ultimately adopts as the interpretation of the "strong inference" standard,[15] it should encompass the following principles which, even before passage of the Reform Act, courts had already begun to articulate as part of a judicial effort to advance the policies that later motivated Congress to pass the Act.

The first principle concerns evaluating allegations not in isolation but in the overall context created by the complaint. The second principle concerns the presence or *absence* of allegations of the defendant's motive to engage in fraud, which plays an important role in determining whether it makes sense to infer that the defendant acted unlawfully. And a third set of principles concerns the problems posed by

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[15] Petitioners have argued above that a complaint states particular facts giving rise to a "strong inference" of scienter when the facts cogently demonstrate a promising and substantial claim on the merits that meaningfully tends to exclude alternative innocent explanations. Certain courts of appeals have expressed a similar concept with somewhat different language. *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005) (stating that even though the "inference need not be ironclad, it must be persuasive"); *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002) (stating complaint should be dismissed if innocent inference "is equally if not more plausible" than culpable inference); *Ottman* v. *Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 348-50 (4th Cir. 2003) (same). The Sixth Circuit has used language that might be read to suggest an even higher burden than that suggested by petitioners. *Helwig* v. *Vencor*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc) (requiring facts that "leave little room for doubt as to misconduct" and allowing complaint to survive only if the inference of scienter is "the most plausible of competing inferences"). As a practical matter, these various verbal formulae all lead to the same outcome in this case because the same set of dispositive principles with respect to inadequate allegations, discussed below, emerge from them all. And all of these formulations of the standard, including that of petitioners, remain true to the text and purpose of the Reform Act, unlike the Seventh Circuit's standard, Pet. App. 20a, which differs little from traditional pleading rules.

ambiguities in pleadings. Those principles, when applied to the Complaint here, require its dismissal.

1. A court reviewing a complaint to determine whether it alleges facts creating a "strong inference" of scienter should take into consideration all the facts and allegations that bear on the question, not just those facts or inferences that might be viewed as favoring the plaintiff's charge. As discussed above, the Reform Act requires a court to consider whether a complaint, assuming the truth of plaintiff's allegations, demonstrates promise for ultimately establishing scienter. A claim's substantial merit can be gauged only in light of the entirety of what is before the court. *Matsushita*, 475 U.S. at 587. Further, to look only at those allegations the plaintiff asserts support the inference of scienter, without paying heed to contrary inferences arising from other facts before the court, is to read the "strong" inference requirement out of the statute. *Pirraglia* v. *Novell, Inc.*, 339 F.3d 1182, 1187 (10th Cir. 2003); *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002); *Helwig* v. *Vencor*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc). The "strength" of facts or allegations can be known only in light of the *overall* context and their relation to other, potentially countervailing or explanatory facts. *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 52 (1st Cir. 2005); *Pirraglia*, 339 F.3d at 1187; *Gompper*, 298 F.3d at 897; *Greenstone*, 975 F.2d at 25. If the Reform Act is to achieve its purpose of deterring and defeating inadequately grounded claims, then courts must look at everything, taken together, to determine whether an assertion of scienter is weak and speculative (and should be dismissed) or well-grounded and strong (and permitted to proceed).

This balanced approach means that if the defendant engages in conduct that is directly at odds with the putative purpose of the alleged fraud, the inference of scienter is correspondingly weakened. For example, a defendant, as here, who is alleged to have fraudulently inflated the company's stock price by misleading investors into believing that demand was strong

would not be expected to announce *in the midst of the alleged fraud* that demand is weakening and that revenue projections are being lowered. See *infra* at 47-48. The "strength" of the inference of scienter with respect to such an alleged fraud simply cannot be determined without taking into account how the inference is severely undermined in light of this conduct.

2. The presence or absence of allegations of a defendant's motive to engage in fraud should also play a role in evaluating the strength of the inference of scienter.[16] Courts, both before and after the Reform Act, *Tuchman*, 14 F.3d at 1068; *DiLeo*, 901 F.2d at 629; *Migliaccio* v. *K-Tel Int'l, Inc.* (*In Re K-Tel Int'l, Inc. Sec. Litig.*), 300 F.3d 881, 894 (8th Cir. 2002); *Florida State Bd. of Admin.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 660 (8th Cir. 2001); *Kalnit* v. *Eichler*, 264 F.3d 131, 142 (2d Cir. 2001), have noted that the absence of allegations as to a plausible motive imposes a heavy burden on the plaintiff to present compelling direct allegations of scienter. This requirement makes sense because the absence of allegations of motive means that a court is being asked to infer that the defendant engaged in wrongdoing "for the sheer joy of it, rather than for profit."

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[16] The courts of appeals have split over whether allegations of motive and opportunity may, independently of other allegations, give rise to a "strong inference" of scienter. *Compare Kalnit* v. *Eichler*, 264 F.3d 131, 139 (2d Cir. 2001), *and In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-535 (3d Cir. 1999), *with Goldstein* v. *MCI Worldcom*, 340 F.3d 238, 246 (5th Cir. 2003), *and City of Phila.* v. *Fleming Cos.*, 264 F.3d 1245, 1249 (10th Cir. 2001), *and Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999), *and Hoffman* v. *Comshare, Inc.* (*In re Comshare Inc. Sec. Litig.*), 183 F.3d 542, 549 (6th Cir. 1999). As discussed below, there are no allegations in this case that any court would recognize as establishing motive, *infra* at 49-50, so this case does not squarely present the question. Nonetheless, for the reasons stated in the previous paragraph, petitioners agree with the majority of circuits that have concluded that motive and opportunity allegations should be considered together with all the allegations and materials before the court to determine whether the allegations, taken as a whole, give rise to a "strong inference" of scienter.

SEC v. *Steadman*, 967 F.2d 636, 642 (D.C. Cir. 1992); *DiLeo*, 901 F.2d at 629.

In antitrust cases, this Court has noted that "the absence of any plausible motive to engage in the conduct charged is highly relevant" to whether the case should continue to trial. *Matsushita*, 475 U.S. at 596. "Lack of motive bears on the range of permissible conclusions that might be drawn from ambiguous evidence." *Id.*; *First Nat'l Bank of Ariz.* v. *Cities Serv. Co.*, 391 U.S. 253, 285-87 (1968) (considering absence of motive of defendant to join conspiracy as bearing on whether other facts are "sufficiently probative" to warrant trial). The absence of motive undermines the strength of other allegations that do not clearly support an inference of scienter.

3. Allegations that are as consistent with innocence as they are with culpability do not satisfy the "strong inference" standard. Indeed, it is difficult to understand how an inference of scienter can be considered "strong" if even on the face of the complaint, and even assuming all well-pleaded facts as true, the claimed culpable inference appears no more plausible than alternative, innocent inferences. Once again, this principle emerges from cases both before and after the Reform Act. *Greenstone*, 975 F.2d at 26; *Mills* v. *Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993); *Garfield* v. *NDC Health Corp.*, 466 F.3d 1255, 1265 (11th Cir. 2006); *Credit Suisse*, 431 F.3d at 49; *Ottman* v. *Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003); *Gompper*, 298 F.3d at 896; *Helwig*, 251 F.3d at 553. It also derives from the core purpose of the Reform Act, which is to prevent speculative claims from proceeding into discovery, where the pressures to settle independent of the merits are overwhelming. A plaintiff that is able to put forth allegations that are merely consistent with culpability to the same extent they are consistent with innocence has done nothing more than raise the possibility of liability. Congress has chosen not to open the doors of litigation to claims so weakly grounded because doing so will, over the run of cases, undermine the

policies of the securities laws more than it will advance them. *Supra* at 27-30.

Once again, this Court's decisions from the antitrust context are instructive. In that context, this Court has said that "conduct that is as consistent with permissible competition as with illegal conspiracy does not, without more, support even an inference of conspiracy." *Matsushita*, 475 U.S. at 597 n.21; *Monsanto*, 465 U.S. at 763-64. Instead, "[t]he evidence must 'tend to exclude the possibility'" of legitimate conduct. *Matsushita*, 475 U.S. at 597 (alteration omitted). Ambiguous allegations or facts are not permitted to support an antitrust judgment because the effect would often be to punish legitimate competition, which is precisely what the antitrust laws are supposed to encourage. *Id.* at 594. Subjecting such an ambiguous claim to further litigation would, therefore, undermine the purpose of the underlying substantive law. Congress has reached a similar conclusion with respect to ambiguous allegations and allowing access to the litigation process in securities cases.

There are at least two different categories of pleading ambiguities that are relevant here and have been discussed in the cases, neither of which should be understood to give rise to a "strong inference" of scienter. One sort of ambiguity, which might be called strategic ambiguity, leaves out details that would clarify whether the identified conduct was either innocent or culpable. It is critical that a complaint include such details if the Reform Act is to perform its purpose of deterring and defeating speculative claims. It was Congress's intent to prevent those pleaders who are unwilling or unable to allege[17] detail sufficient to distinguish culpable from innocent conduct from imposing the costs of litigation on the

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[17] An allegation is not itself proof, but it may be put forth after the plaintiff determines that he has some "evidentiary support" for the assertion. Fed. R. Civ. P. 11(b)(3).

defendants, the courts and ultimately the capital markets and U.S. economy.

Hostility to strategically ambiguous pleading is well rooted in our legal tradition. The common law penalized ambiguous pleaders. *United States* v. *Linn*, 42 U.S. 104 (1843), involved an action against several defendants who were parties to a debt instrument. One of the defendants pleaded that after he signed his name to the debt instrument, it was altered without his consent by affixing seals to his signature. *Id.* at 110. The pleading did not state whether the alteration was made without the knowledge or consent of the plaintiff, in which case the alteration would not have affected the defendant's liability. *Id.* This Court held that in such a circumstance, the pleading "is to be construed most strongly against" the pleader. *Id.* "[T]he reason assigned for this rule of construction, is, that it is a natural presumption, that the party pleading will state his case as favourably as he can for himself. And if he does not state it with all its legal circumstances, the case is not favourable to him ...." *Id.* at 110-11.

This Court again emphasized this rule of pleading in *Stuart* v. *United States*, 85 U.S. 84 (1873). There, plaintiffs sought recovery under a statute authorizing reimbursement to government contractors whose property had been destroyed "by an enemy" when the property at issue was in the military service of the United States. This Court affirmed dismissal of the petition as insufficiently pleaded where it was alleged that the property was destroyed by "'a band of hostile Indians.'" *Id.* at 87. The Court observed that plaintiffs failed to plead "to whom or to what these Indians were hostile," stating, "[t]hey may have been hostile to the government of the United States, they may have been hostile, inimical, or unfriendly to the owners of the cattle only." *Id.* at 87-88. Because the pleader had failed to state whether the Indians were hostile to the United States, "[t]he law assumes that these deficiencies in it

exist because the petitioner could not with advantage to his case supply them." *Id.* at 88.

As *Linn* and *Stuart* demonstrate, the common law required the pleader to allege his case as strongly as he could, and inferred a weak case from ambiguity. The mere possibility that facts uncovered later would clarify the ambiguity and support the pleader was insufficient to allow the claim to survive. Likewise, in the Reform Act, Congress has chosen to insist that the plaintiff plead the case as favorably as he can. Courts should infer a weak case (and dismiss the complaint) if the plaintiff can produce facts that do no more than raise a mere possibility of liability arising from ambiguity.[18]

Another kind of ambiguity concerns conduct or circumstances that are just as likely to be associated with innocence as wrongdoing. Such ambiguous allegations have been asserted with respect to a wide range of alleged conduct, including, for example, knowledge based on mere access to documents (as opposed to actually reviewing them) by virtue of a defendant's status as an executive of the company, or motive to engage in fraud merely by virtue of a standard incentive compensation plan, or ordinary trading activity.

Once again, both before and after the Reform Act, *Acito* v. *IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995); *Shields*, 25 F.3d at 1130; *Tuchman*, 14 F.3d at 1068-69; *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1424 (3d Cir. 1997) (Alito, J.) (decided under pre-Reform Act law); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 539 (3d Cir. 1999); *Ottman*, 353 F.3d at 352; *Green Tree*, 270 F.3d at 655, courts have held that such allegations do not support an

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[18] Even today the federal pattern jury instruction for fraud states, "If a transaction that is called into question is equally capable of two interpretations, one honest and the other fraudulent, it should be found to be honest." 3 *Federal Jury Practice & Instructions* § 123.10 (5th ed. 2007).

inference that the defendant possessed fraudulent intent.[19] And once again, the purpose of the Reform Act makes clear that these courts are correct. If ordinary conduct itself created a "strong inference" of scienter, then nearly every case would satisfy the "strong inference" standard. See *Monsanto*, 465 U.S. at 762-63 (an antitrust plaintiff may not survive summary judgment by presenting evidence that a "manufacturer and its distributors are in constant communication about prices" because they "have legitimate reasons to exchange information about the prices and the reception of their products in the market"; same for evidence that manufacturer received complaints from distributor about "price-cutters" because such complaints "arise in the normal course of business"). The Reform Act's substantive pleading requirement would become nothing more than an empty command to invoke certain magic words in a pleading if commonly occurring, ambiguous conduct sufficed to create a "strong inference" of scienter. Strike suits would not be reduced; they would become formulaic.

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As discussed more fully below, the Seventh Circuit did not apply the pleading principles discussed above to the allegations of the Complaint. To the contrary, the Seventh Circuit chose to give the respondents the benefit of the doubt created by their ambiguous allegations, and refused to place the allegations in their full context. The Seventh Circuit expressly shied away from interpreting the "strong inference" standard as imposing a rigorous pleading requirement because

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[19] The Second Circuit has, for example, catalogued certain impermissible allegations of "motives possessed by virtually all corporate insiders." *Novak* v. *Kasaks*, 216 F.3d 300, 307-08 (2d Cir. 2000) (listing "the desire to maintain a high corporate credit rating, or otherwise sustain 'the appearance of corporate profitability, or of the success of an investment,' and ... the desire to maintain a high stock price in order to increase executive compensation, or prolong the benefits of holding corporate office") (citations omitted).

of an unexplained concern about the Seventh Amendment. Pet. App. 20a. In fact, no court has *ever* offered a substantial analysis of a Seventh Amendment objection to the Reform Act, and respondents have not raised a Seventh Amendment challenge to the "strong inference" standard at any stage of these proceedings. That is because there is no basis for such concerns.

First, the Seventh Amendment is not implicated by the Reform Act because, like this Court's decision in *Matsushita*, the "strong inference" standard defines the range of permissible inferences that may be drawn from the facts alleged in light of the need to protect the policies of the securities laws from being undermined. If this Court may narrow the range of permissible inferences in light of the policies of the underlying substantive law without running afoul of the Seventh Amendment, as it did in *Matsushita*, 475 U.S. at 593-94, then clearly so may Congress.

Second, the Seventh Amendment protects only the common law right to a jury. See *Colgrove* v. *Battin*, 413 U.S. 149, 153-56 (1973) (explaining that the Seventh Amendment exists to preserve "the right to trial by jury in civil cases where it existed at common law"). The common law pleading rules discussed in *Linn* and *Stuart* thus further support the constitutional authority of Congress to set the heightened pleading standard it adopted in the Reform Act. The willingness of common law courts to dismiss a weak case because of ambiguous pleading fully supports the authority of Congress to mandate that courts evaluate the substantial merit of a statutory claim at the pleading stage. Indeed, at common law a case might be dismissed for failure adequately to plead the case even though a valid judgment could be entered based on the same pleading. 1 Chitty & Chitty, *A Treatise on the Parties to Actions and on Pleading* 236 (6th ed. 1836) (stating that a pleading might be "good after verdict" even though it "could not have been supported on demurrer"). What Congress has legislated in the Reform Act is no more

offensive to the jury right than were these common law pleading rules.[20] Therefore, what Congress has done cannot be said to offend the Seventh Amendment.

II. THE SECOND AMENDED COMPLAINT FAILS TO ALLEGE PARTICULAR FACTS GIVING RISE TO A STRONG INFERENCE OF SCIENTER.

To best guide lower courts in both articulating *and applying* the Reform Act's "strong inference" standard consistently in future cases, this Court should itself apply the Reform Act standard for pleading scienter and the generally applicable pleading principles discussed above to the allegations in this case. Indeed, as troubling as the legal standard articulated by the Seventh Circuit was, the way that court actually applied its standard reflects a particularly lax and pro-plaintiff approach, which flatly undermines the purposes of the Reform Act. A review of the Complaint's allegations pertaining to Notebaert in light of the proper standard and all the materials properly before the court reveals that the district court correctly dismissed the Complaint.

All of the allegations relied upon by the Seventh Circuit to support its conclusion that the facts give rise to a "strong inference" of Notebaert's scienter are, at best, ambiguous. (And Notebaert's scienter is the lynchpin for all remaining claims.) For that reason alone, the district court's dismissal of the Complaint should have been affirmed. Further, the Seventh Circuit failed to consider how the allegations related to Notebaert's scienter were weakened by the context illuminated by the record taken as a whole. The Seventh Circuit ignored the fact that the Company publicly announced that it was *reducing* its financial projections in the midst of

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[20] "[M]any procedural devices developed since 1791 ... have diminished the civil jury's historic domain have been found not to be inconsistent with the Seventh Amendment." *Parklane Hosiery Co.* v. *Shore*, 439 U.S. 322, 336 (1979).

what is alleged to be a fraud inflating those very projections. The absence of any allegations of a plausible motive is also noteworthy, especially in light of the fact that the alleged fraud is claimed to have suddenly ceased only seven months after it began, and no rational explanation for Notebaert either to have started or stopped the alleged fraud has been put forward. Taken as a whole (or even in isolation) the allegations of the Complaint fail to give rise to a "strong inference" of Notebaert's scienter.

1. The Seventh Circuit concluded that the Complaint adequately alleged facts giving rise to a "strong inference" that Notebaert knew Tellabs' financial results for the fourth quarter of 2000 were falsely inflated. The only allegations on which the Seventh Circuit relied, or could have relied, regarding the fourth quarter financial results are those related to "channel stuffing." Pet. App. 25a. But the allegations connecting Notebaert to the alleged "channel stuffing" are ambiguous, and apparently intentionally so.

The Complaint defines "channel stuffing" broadly to include legitimate conduct (such as offering customers discounts of 10% or 20%) as well as potentially illegitimate conduct (such as writing orders for products customers had not requested). JA 110, 112, ¶¶ 62-63, 69. Both the district court and the Seventh Circuit properly refused to draw any inference of scienter based on offering discounts to customers. Pet. App. 13a (Seventh Circuit relying only on claim that Tellabs provided "its downstream customers with unordered TITAN 5500s"); *id.* at 58a, 74a, (district court noting that offering customers discounts is legitimate conduct that does not support an inference of scienter). Indeed, the district court had dismissed an earlier version of the complaint, and had specifically informed respondents that offering discounts was legitimate, nonactionable conduct. *Id.* at 99a-100a. Despite the opportunity to replead after the district court identified this critical ambiguity, respondents did not narrow their definition of "channel stuffing," or

specify which "channel stuffing" conduct Notebaert was alleged to have known about. Respondents maintained their ambiguous allegations.

Particularly in light of that broad definition of "channel stuffing," the vague allegations that Notebaert "worked directly with Tellabs' sales personnel" to engage in unspecified "channel stuffing" and "unquestionably knew about the channel stuffing activity relating to the TITAN 5500," JA 111, 157, ¶¶ 67, 156, amount to nothing more than that he *may* have known of either illegitimate or legitimate conduct. As the Eleventh Circuit recently observed, "[a] general allegation that Individual Defendants promoted channel stuffing at a series of meetings does not establish scienter." *Garfield*, 466 F.3d at 1265; see *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 203 (1st Cir. 1999) (channel stuffing allegations do not give rise to a strong inference of scienter because "[u]nlike altering company documents, there may be any number of legitimate reasons for attempting to achieve sales earlier"). Having left their "channel stuffing" allegations ambiguous, it was merely "possible to surmise" that Notebaert acted with scienter, but a mere possibility is insufficient. *Garfield*, 466 F.3d at 1265.

Respondents' allegations concerning Notebaert's unspecified involvement in channel stuffing are functionally identical to those found wanting in *Linn* and *Stuart*. In *Linn*, the pleader said only that the document had been altered, but did not specify whether the plaintiff knew. *Linn*, 42 U.S. at 110. In *Stuart*, the pleader said only that the "band of Indians" was "hostile," but did not specify whether the band was hostile to the United States. *Stuart*, 84 U.S. at 87. Here, respondents say only that Notebaert knew of "channel stuffing," but do not specify that Notebaert knew of the illegitimate kind of "channel stuffing." Nothing in the Complaint "tends to exclude" the innocent possibility. *Matsushita*, 475 U.S. at 588. As a result, the allegations in the Complaint are at least as consistent with innocence as they are

with culpability. They do not, therefore, give rise to a "strong inference" of scienter.

2. The claim that Notebaert acted with scienter when allegedly falsely expressing confidence in customer demand for the TITAN 5500 fares no better.[21] In holding that the Complaint adequately alleged facts giving rise to a strong inference that Notebaert acted with fraudulent intent, the Seventh Circuit relied on allegations concerning two different sets of reports that allegedly showed that demand was weakening: the Probe Research Report and certain (unspecified) internal quarterly status reports. Pet. App. 23a. But the details regarding the timing of each of these reports are pled in a strategically ambiguous way.

In order to support an inference that Notebaert's statements regarding the TITAN 5500 were knowingly false, the Probe Research Report's conclusions had to have been delivered to Tellabs *before* Notebaert made the statements *and* Notebaert also had to have been aware of the report's conclusions before those statements were made. The Complaint, however, is deliberately ambiguous on these critical questions of timing. The Complaint vaguely alleges that the Probe Research Report "was *completed* in *or about* early 2001," JA 103, ¶ 39 (emphasis added); it does not allege when anyone at Tellabs received the report, or when, if ever, Notebaert was made aware of its conclusions. Once again, the allegations of the Complaint are as consistent with innocence (that Notebaert did not learn of the report's conclusions, if at all, until *after* the statements in question) as with culpability (that he learned of the report's conclusions before the statements). And

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[21] The Seventh Circuit discussed statements related to demand for the TITAN 5500 made in February, March and April 2001. Pet. App. 23a. But the Seventh Circuit itself had concluded that "it was not until March 2001 that the TITAN 5500's declining status was obvious," *id.* at 24a, which means that the facts alleged do not give rise to a "strong inference" of scienter as to any February statements.

nothing in the Complaint tends to exclude the innocent possibility.

Ambiguity as to timing is critically significant here for another reason. Other facts properly before the court undermine whatever weak inference of scienter respondents' ambiguous allegations may support. Indeed, the record indicates that Notebaert and Tellabs were continually processing new information regarding the Company's future prospects and quickly informing the public of changes as information became available.

It is undisputed that Tellabs' first quarter revenue *increased* by 21% over the previous year. JA 43. Still, on April 6, 2001, Tellabs began lowering its first quarter revenue projections because, as Notebaert expressly disclosed, there was an unanticipated fall-off in orders for the TITAN 5500 during the last two and a half weeks of March (which is the end of the first quarter). JA 36-37. This fact is especially significant in light of the Seventh Circuit's reliance on alleged internal marketing reports showing a weakening in demand to support the inference of scienter. Pet. App. 23a. Those marketing reports were alleged to have been produced in "March 2001," JA 104, ¶ 40, yet another strategically ambiguous date.[22] "March 2001" includes the last two and a half weeks of March, which is significant because on April 6 Notebaert publicly said that the Company began experiencing a fall-off in anticipated orders. Moreoever, less than two weeks later, on April 18, Tellabs lowered its revenue projections for full year 2001 to an amount that was $800 million less than originally forecast. This update is twice as great as the $400 million that was allegedly forecast by the internal reports

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[22] Obviously, a "March 2001" report cannot be the basis for an inference of scienter with respect to any alleged false statement in February 2001. In addition, there is nothing in the Complaint to suggest that the "March 2001" internal report was produced or made known to Notebaert in advance of his March 8, 2001 allegedly misleading statement.

upon which the Complaint, and the court of appeals, relied to support a strong inference of scienter. Pet. App. 23a; JA 104, ¶ 39.

In context, the claimed inference of scienter becomes extraordinarily weak, if not nonexistent.[23] Respondents are asserting that Notebaert was knowingly misleading the public about Tellabs' financial projections, and the strength of demand for the Company's principal product, for the entire first half of 2001. Yet, right in the middle of that time-frame, Notebaert announced that Tellabs experienced an unexpected fall-off in orders, and, as a result, reduced its financial projections by an amount greater than respondents allege that the reports (which may or may not have yet been known to Notebaert) suggest. The Seventh Circuit concluded that the inference of scienter was "strong" only by ignoring the illuminating context. The Reform Act rejects that approach.

3. The Seventh Circuit also relied on ambiguous allegations in concluding that the Complaint adequately alleged facts supporting a strong inference of scienter with respect to Notebaert's statements that the TITAN 6500 product was being shipped and that demand for the product was "strong."

First, the Seventh Circuit pointed to the allegation that, according to a former Tellabs sales director, "Tellabs management viewed weekly and monthly reports concerning a variety of issues, *including the status of product development*," and "Tellabs' sales personnel wrote up weekly sales projection reports." Pet. App. 24-25a; JA 155, ¶ 153(f). This allegation says nothing specifically about Notebaert's alleged knowledge regarding the TITAN 6500. Nothing about these allegations even suggests that any of these unidentified reports spoke about or called Notebaert's attention to issues related to the TITAN 6500. Instead, this allegation is nothing

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[23] The absence of any allegations providing a motive either for Notebaert or the Company to engage in fraud further weakens the inference of scienter, as discussed below. *Infra* at 50.

but a generic statement about the role of management in any corporation: to keep abreast of the broad financial condition of the company. As noted above, numerous cases have long recognized that such allegations do not support an inference of scienter, much less a strong one. *Supra* at 40-41.

Second, the Seventh Circuit erroneously concluded that respondents had alleged that "a former high-level sales executive[] reported that Notebaert knew that 'the TITAN 6500 was not ready for deployment despite Tellabs' public announcements.'" Pet. App. 25a (alteration in orginal). The allegation actually says that *other defendants* (as to whom the Section 10(b) claims were abandoned on appeal) knew that the TITAN 6500 was not ready for deployment. JA 107, ¶ 53. Respondents did not allege the same as to *Notebaert*.

As to Notebaert, the allegation says only, "Notebaert also knew about the TITAN 6500 problems." JA 108, ¶ 53. This allegation is strategically ambiguous regarding *what* "problems" Notebaert allegedly knew about and, importantly, *when*, especially in light of the fact that the paragraph in the Complaint begins by explaining that the TITAN 6500 had suffered development problems from 1998 through 2001 "and thereafter." *Id.* at 107, ¶ 53. The Complaint does nothing to exclude the possibility that, for example, Notebaert knew only of alleged problems with the TITAN 6500's development from 1998 and 1999. Further, the confidential informant supporting this allegation had left the Company before the class period had begun. JA 91; Pet. App. 74a. There is thus little reason to believe that the ambiguous allegation regarding Notebaert is addressed to information in Notebaert's possession at the time he made the allegedly false statements, which is *after* the informant left the Company.

4. For all the reasons identified above, the allegations in this case fall far short of satisfying the Reform Act's "strong inference" standard. But even if the ambiguous allegations discussed above were sufficient to make this a close case, there still would remain one powerful reason to dismiss the

Complaint. The Complaint here fails to identify any plausible motive for Notebaert to have committed fraud for the limited period from December 11, 2000 to June 19, 2001. The Complaint does not allege that Notebaert personally benefited financially, through stock sales or otherwise, during the seven-month period that the stock price allegedly was artificially inflated. Nor does the Complaint allege that Tellabs benefited in any way. Plaintiffs do not allege that there were any Company activities during this limited period of time—such as offerings, mergers, or exchanges—that would somehow have been facilitated by an artificially inflated stock price.

The absence of any allegations of motive color all the other allegations putatively giving rise to an inference of scienter. Respondents would have this Court believe that Notebaert began to execute a scheme to defraud investors and inflate the Company's stock price beginning in December 2001, and suddenly ended the scheme only seven months later, for no reason. This leap of faith is not the sort of inference courts lightly indulge. *Shields*, 25 F.3d at 1130 ("It is hard to see what benefits accrue from a short respite from an inevitable day of reckoning."); *supra* at 36-37. And in this case, the absence of motive must be combined with the fact that Notebaert publicly announced in the middle of the seven-month period that the Company's customers were exercising new-found caution in placing orders, and that the Company's financial outlook was weakening. Viewed in their full context, respondents' strategically ambiguous allegations support at most the weakest of inferences of scienter. The inference all but disappears. If the allegations in this Complaint give rise to a strong inference of scienter, then the strong inference standard of the Reform Act is a dead letter.

CONCLUSION

For the foregoing reasons, the decision of the Seventh Circuit should be reversed.

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February 9, 2007